

The joys of being a creditor nation

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China is on track to add between \$250 and \$300 billion to its reserves this year. That is a lot of money. Enough to have an impact on global bond markets. Enough to buy several [oil companies](#). As the [FT notes](#), most of the financing for CNOOC's bid for Unocal is coming from inside China.

The more energy companies -- or [appliance makers](#) -- that China buys, the smaller the increase in its reserves. Rather than the People's Bank of China buying "reserve" assets like Treasuries, agencies and mortgage backed securities, state-owned companies (and perhaps some private Chinese firms as well) are interested in buying equity in US firms. From a "balance-of-payments point of view, one external asset -- a low-yielding Treasury -- is replaced by another -- an oil firm with ownership stakes in several Asian oil and gas fields.

The US can add to its [external assets too](#). But since the US is running a current account deficit, it can only do so, in aggregate, by taking out a loan from one set of foreigners to buy (or build) other foreign assets. China also is attracting large inflows from abroad -- both FDI and hot money. But even in the absence of these inflows, China's external assets would be increasing. China, unlike the US, has a large and growing current account surplus, or, put differently, spare savings to invest abroad.

The *Economist* mentions [two reasons](#) for China's new acquisitiveness:

China's move for Unocal neatly sums up the two forces driving the country's ongoing bid to acquire foreign assets: the thirst for raw materials to feed and maintain its booming economy, and the desire to obtain western brands to help market Chinese exports

I would add a third: oil fields are likely to offer China a better return than Treasuries. China has all the liquid dollar reserves it needs, and oil may hold its value better than a long-term unsecured dollar-denominated loan to the US government.

No doubt, China's demand for oil -- and its interest in investing in future oil production is emerging as a potential source of [friction between the US and China](#).

Chinese analysts say that once the country became a net importer of crude in the early 1990s, tensions with the United States were inevitable.

"China is a late-comer and the U.S is entrenched and dominates the market... Collisions, and frictions are unavoidable when we try to enter," said Chen Fengying of the China Institute of Contemporary International Relations.

China clearly is willing to invest in places -- [like Iran](#) -- that the US is not. And the US government may have to decide whether it is willing to allow a state-owned Chinese firm to control a small part of the US domestic oil industry. Note the Bob Kerrey quotes in this [FT article](#), and the Thomas Donnelly quote [here](#). I suspect that we will hear a lot about CFIUS in the near future.

But it is worth remembering that 70% of the top three US oil firms' reserves are outside the US, while only 10% of the top three Chinese firms' reserves are outside the China (credit for this point goes to an anonymous source). China's oil firms have cash and customers but not enough oil: their current interest in stretching their wings abroad makes a certain amount of commercial sense.

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There are lots of ["China prices"](#) in the world economy these days. There is the China price for US treasuries and mortgages -- all the money China invests in these markets keeps prices up and interest down. Haier's big for Maytag, Lenovo's bid for IBM's PC business and CNOOC's bid for Unocal combine to less than \$25 billion. That is far less than China's roughly \$70 billion in recorded purchases of US debt in 2004, and far, far less than a reasonable estimate of the real purchases of US debt by China's central bank -- which would total around \$145 billion in 2004 if it invested 75% of its new reserves in US assets (assuming all those funds flowed into the capital market and were not used to build up China's overseas bank accounts). But even if the dollars that

China has invested in "oil" pale in comparison with the dollars China has invested in Treasuries, there is little doubt that China is changing the world's oil balance, not just the world's savings and investment balance.

Many have noted that the surge in Chinese demand -- particularly pronounced in 2004 -- is one reason why oil markets are tight. New Chinese drivers are bidding against American drivers and their fuel-hog SUVs for an increasingly scarce commodity.

But that is not the only way China is changing the oil market. China increasingly is a major source of investment capital, not just a source of demand. And since China's oil industry is state-controlled, that means state firms are playing a bigger role in the oil business. That is happening for another reason as well. The Economist [survey of the oil industry](#) accurately noted that most of the world's remaining oil reserves are now in countries where a local national firm has a monopoly on the exploitation of the country's oil. Think Saudi Aramco. The future world may be one where state-owned national production companies in the oil states interact with Chinese state owned companies that will market their oil.

Incremental supply can be brought online to meet incremental demand without the involvement of the Western oil majors.

***State-owned oil companies** are emerging as a new aggressive force on world markets once dominated by two main sets of investors -- producing countries and Western majors such as Chevron, BP and ExxonMobil*

China's national firms, sourcing fuel for the world's fastest growing major economy, are among the most voracious.

"In the past several years, a new force has emerged in the global oil business -- the national oil companies," said Kang Wu, a research fellow at the East-West center in Hawaii.

"Their overseas push in upstream is quite aggressive.... They can offer terms which the other majors do not think justifiable in terms of economics," he added.

From one point of view, it matters little whether Chinese firms or US firms or European firms invest in the actual production of oil. Once the oil has been found, any commercial firm will sell it to the highest bidder, regardless of nationality.

China may not see it that way. It may believe Chinese investment will increase the security of China's oil supply -- even if the oil is still shipped to China through sea lanes controlled by the US Navy. Or it may be acting for purely commercial reasons. Better oil than Treasuries yielding 4% nominal, particularly since the dollar is likely to fall against the renminbi. Most likely, China's motives are mixed.

What is clear is that this is but one of many ways that China's emergence will change the world. The US has grown used to Chinese demand for Treasuries. It is a bit less comfortable with the result (**\$60 a barrel**) of Chinese demand for oil. It remains to be seen if the US is ready for a Chinese bid for a much broader range of assets.

Comments